

90-126
No. - - -

(1)

Supreme Court, U.S.

FILED

JUL 12 1990

JOSEPH F. SPANIOLO, JR.
CLERK

In The

Supreme Court of the United States

October Term, 1990

STEPHEN GAJDOS,

Petitioner,

vs.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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QUESTIONS PRESENTED

1. May the government prove a criminal tax offense basing their prosecution on a cash method computation of tax liability, when the petitioner maintained inventory in his business and was therefore required by IRS regulations to compute his tax liability using the accrual method of accounting?

2. In an indirect proof case based on the bank deposits method, once it comes to the government's attention that the taxpayer's business utilizes inventory, is the government obligated to investigate the accuracy of the taxpayer's returns based on an accrual method of accounting?

LIST OF ALL PARTIES

The caption of the case in this Court contains the names of all parties (Stephen Gajdos and the United States of America).

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No.

In The

Supreme Court of the United States

October Term, 1990

STEPHEN GAJDOS,

Petitioner,

vs.

UNITED STATES OF AMERICA,

Respondent.

**PETITION FOR WRIT OF CERTIORARI TO THE UNITED
STATES COURT OF APPEALS FOR THE THIRD CIRCUIT**

Petitioner Stephen Gajdos respectfully petitions this Court for a writ of certiorari to review the judgment of the United States Court of Appeals for the Third Circuit entered on June 15, 1990 affirming petitioner's conviction and prison sentence of 15 months.

OPINIONS BELOW

The unpublished judgment order of the Court of Appeals filed on May 2, 1990 appears in the appendix at 3a. The order

of June 7, 1990 by the Honorable Edward Becker denying petitioner's application for rehearing or a hearing en banc appears in the appendix at 1a.

STATEMENT OF JURISDICTION

The judgment of the United States Court of Appeals for the Third Circuit was entered on May 2, 1990. A timely petition for rehearing and for a rehearing en banc was denied on June 7, 1990. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1). This petition is filed timely pursuant to Rule 13(1), Rules of the Supreme Court of the United States.

CONSTITUTIONAL PROVISIONS AND RULES INVOLVED

26 U.S.C. § 446(a); Reg. 1.446-1(a)(2) provides:

It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principals in a particular trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

26 U.S.C. § 446(a); Reg. 1.446-1(c)(2)(i) provides:

Special Rules — (i) In any case in which it is necessary to use an inventory the accrual method

of accounting must be used with regard to purchases and sales unless otherwise authorized under subdivision (ii) of this subparagraph.

STATEMENT OF THE CASE

Petitioner, Stephen Gajdos, owned and operated a one-man business in which he distributed and re-sold plastic packaging. Mr. Gajdos maintained inventory in his garage, his home and a nearby warehouse. Additionally, he often ordered merchandise FOB from a manufacturer's plant and shipped it, at his expense, directly to his customer. By transacting business in this manner title passed to Mr. Gajdos at the time the merchandise left the manufacturer's plant and he bore the risk of loss. Such merchandise is, thus, included in inventory. See IRS Reg. 1.471-1. Because Mr. Gajdos' business maintained inventory, it was mandatory that he calculate his income tax based on an accrual method of accounting. IRS Reg. 1.446-1(c)(2).

The particular tax returns at issue were Mr. Gajdos' 1982 and 1983 tax returns. The returns were ambiguous and internally inconsistent as to what method of accounting Mr. Gajdos had utilized. While he checked the box on his 1982 return that he utilized a cash accounting method, the return contained numerous indications that he employed an accrual method of accounting in preparing the return. Specifically, the return reflected that inventory had been valued at cost; a bad debt loss was claimed for both years; there was a figure listed for cost of goods sold; and inventory was noted on the 1982 return.

The government audited Mr. Gajdos' returns in 1985 and referred them for criminal prosecution. In determining whether the returns understated income, the government investigation utilized an indirect method of proof involving a comparison of the petitioner's bank account deposits and his reported income.

Notwithstanding the fact that the government investigator knew the nature of Mr. Gajdos' business, and that he maintained inventory in his home, he never asked Mr. Gajdos about it nor investigated it. The government determined that a deficiency existed and proceeded to prosecute Mr. Gajdos analyzing his return, not on an accrual basis of accounting, but exclusively on a cash basis.

Pretrial, petitioner moved *in limine* to require the prosecution to prove the alleged tax violations based on the accrual method of accounting. Additionally, the court denied requested instructions to the effect that the jury must evaluate the tax returns on an accrual basis as well as additional requests for charge that clarified the significance of inventory and of the FOB manner of sale utilized by petitioner.

REASONS FOR GRANTING THE WRIT

I.

The Third Circuit's affirmance of petitioner's conviction based on calculations utilizing a cash method of accounting contradicts a longstanding rule of law in this Court and conflicts with a prior decision from the Ninth Circuit.

The Court in *Holland v. United States*, 348 U.S. 121, 99 L. Ed. 150, 75 S. Ct. 127 (1954) held that where the government's proof in a tax prosecution, rests upon an indirect method, like a net worth or bank deposits analysis, the government is obligated to investigate all reasonable leads put forward by the taxpayer which would furnish a nontaxable source of the increase in net or of the bank deposits. In *United States v. Allen*, 522 F.2d 1229 (6th Cir. 1975) the Sixth Circuit held that the government's obligation arising from *Holland v. United States*, *supra*, includes the obligation to investigate accounts receivable in existence prior

to the opening net worth date when the taxpayer under investigation reported his income on an accrual method.

In *United States v. Hall*, 650 F.2d 994 (9th Cir. 1981) the Ninth Circuit held that the required scrutiny under *Holland, supra*, arose where the government prosecution was based on a bank deposits method of proof. In *Hall*, the Ninth Circuit reversed due to the government's failure to adequately calculate and value the taxpayer's business inventory.

In the present case, despite the nature of the petitioner's business and various evidentiary facts brought to the attention of the Internal Revenue Service agent both the civil audit and the subsequent criminal prosecution analyzed the petitioner's tax returns solely on a cash basis of accounting. The failure to consider and value inventory and its effect on petitioner's income was a violation of the government's obligation under *United States v. Holland, supra*, and cannot be reconciled with the Ninth Circuit decision in *United States v. Hall, supra*.

II.

In affirming petitioner's conviction, the Third Circuit departed from the accepted and usual course of judicial proceedings so as to call for exercise of this Court's power of supervision.

Given the nature of Mr. Gajdos' business and the importance of inventory to that business 26 U.S.C. § 446(a); IRS Reg. 1.446-1(c)(2)(i) provides that petitioner's income must be calculated on an accrual accounting basis. See also, *Knight-Ridder Newspapers v. United States*, 743 F.2d 781 (11th Cir. 1984). Notwithstanding this regulation, the government prepared and tried its case on the basis that Mr. Gajdos was a cash basis taxpayer and that the disparity between his bank deposits and the gross

income reported on his return proved that he knowingly and willfully filed a false tax return.

The fallacy with this analysis is that one explanation for this disparity is that when a taxpayer's business utilizes the accrual method of accounting, money deposited in a particular year could have been income in the prior year. When this is the case, some portion of the bank deposits in a particular calendar year reflect income earned in a prior year.

The government's insistence on evaluating an accrual taxpayer's return on a cash basis led the trial court in the *United States v. Hestnes*, 492 F. Supp. 999 (W.D. Wis.) to grant the taxpayer's post-verdict motion for a judgment of acquittal. The method utilized by the government in *Hestnes* was a "specific items" analysis wherein the government attempted to prove tax evasion by showing that the taxpayer pocketed specific receipts from specific customers without depositing them in his business bank account and without reporting them as income on his tax return. The court overturned the conviction as the government failed to negate the explanation that the receipt of monies under an accrual basis of accounting represented income on which tax was reported and paid in a prior year.

Curiously enough, the Third Circuit, in making short shrift of the petitioner's argument that the government was obligated to evaluate whether his bank deposits reflected income earned in a prior year under an accrual method of accounting reflects insensitivity to the very issue that had been the basis of a reversal in an earlier circuit decision. In *United States v. House*, 524 F.2d 1035 (3rd Cir. 1975) the government based its prosecution of a cash basis taxpayer on the allegation that he withheld certain checks received in one calendar year for deposit in a subsequent year. The Third Circuit reversed the conviction and held that simply because these checks were dated in the earlier calendar year did

not prove that they were improperly withheld for deposit in a later year. Most significantly, the court found that the mere fact that these checks were deposited in a year subsequent to the calendar year in which they were written was not sufficient evidence of willfulness to sustain the taxpayer's conviction of attempting to evade payment of federal income tax.

In conclusion, what is offensive about petitioner's conviction, and the Third Circuit's affirmance thereof, is that applicable, mandatory government regulations require him to prepare his returns and report his income on an accrual basis. Notwithstanding this legal requirement the government analyzed his returns on a cash basis. His conviction was affirmed despite the fact that the government was fully aware of the nature of petitioner's business and that it maintained inventory and yet failed to negate this nontaxable explanation for some of the monies reflected as bank deposits.

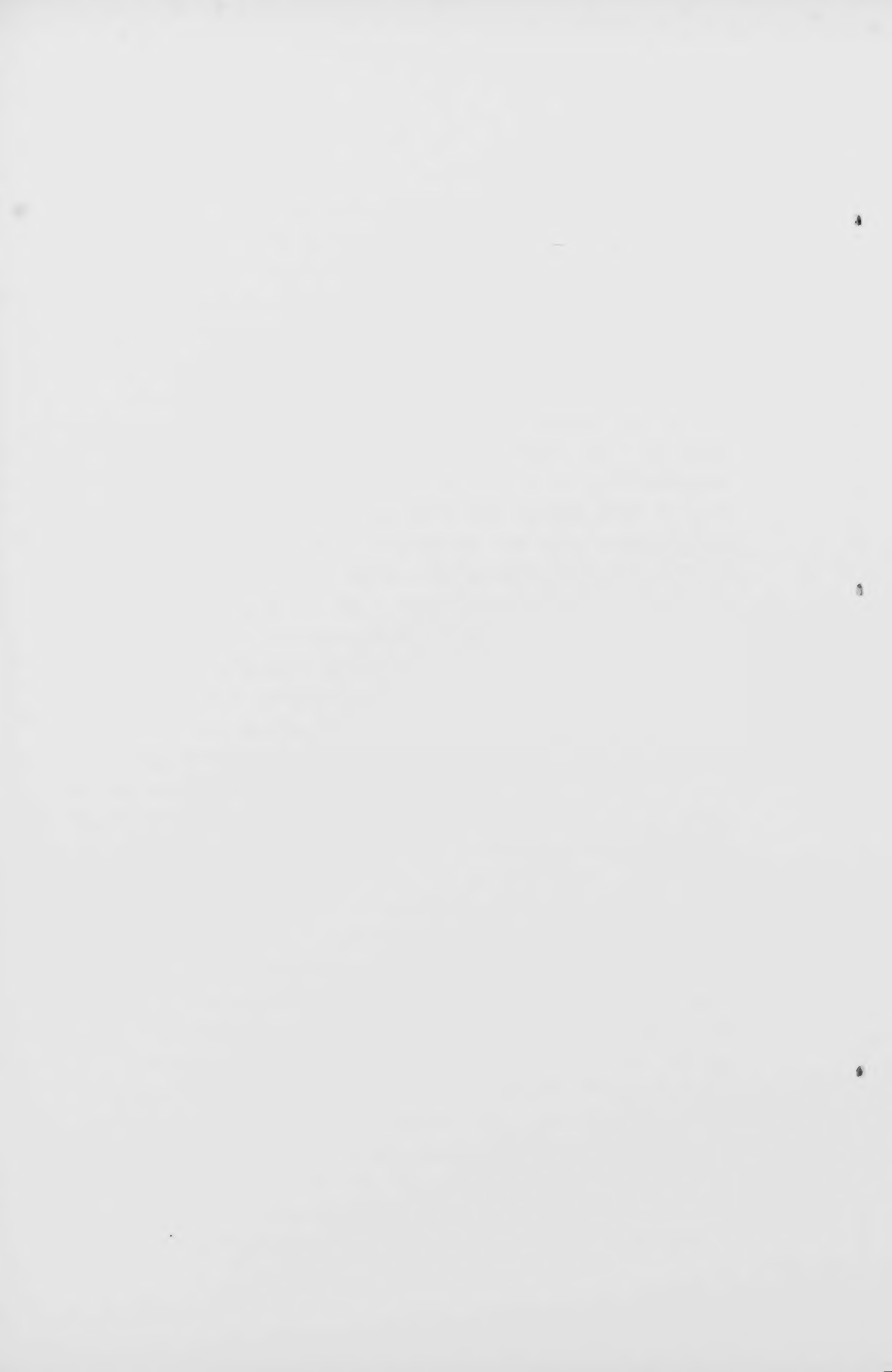
To let this conviction stand would be to sanction the lower court's departure from the accepted safeguards established by this court in *United States v. Holland, supra*, and followed by the Ninth Circuit in *United States v. Hall, supra*.

CONCLUSION

For each of the foregoing reasons, petitioner Stephen Gajdos requests that this Court grant his petition for a writ of certiorari to review the judgment order of the United States Court of Appeals for the Third Circuit.

Respectfully submitted,

JACK MEYERSON
Attorney for Petitioner



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**APPENDIX A — ORDER DENYING PETITION FOR
REHEARING DATED JUNE 7, 1990**

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 89-1906

UNITED STATES OF AMERICA

v.

STEPHEN GADJOS,

Appellant

(E.D. PA CRIMINAL NO. 89-00100-01)

PRESENT: HIGGINBOTHAM, *Chief Judge*, SLOVITER,
BECKER, STAPLETON, MANSMANN, GREENBERG,
HUTCHINSON, SCIRICA, COWEN and NYGAARD, *Circuit
Judges*, and GARTH, *Senior Circuit Judge*.*

The petition for rehearing filed by appellant having been submitted to the judges who participated in the decision of this Court and to all the other available circuit judges in active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court in banc, the petition for rehearing is DENIED.

* As to panel rehearing only.

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Appendix A

BY THE COURT,

s/ Edward R. Becker
Circuit Judge

Dated: June 7, 1990

**APPENDIX B — JUDGMENT ORDER OF THE UNITED
STATES COURT OF APPEALS FOR THE THIRD CIRCUIT
FILED MAY 2, 1990**

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

NO. 89-1906

UNITED STATES OF AMERICA

v.

GAJDOS, STEPHEN,

Stephen Gajdos, Appellant

Appeal from the United States District Court for the Eastern
District of Pennsylvania
(D.C. Criminal No. 89-00100-01)
District Judge: Honorable Louis H. Pollak

Submitted Under Third Circuit Rule 12(6)
Tuesday, April 24, 1990

BEFORE: BECKER, GREENBERG
and GARTH, *Circuit Judges*

JUDGMENT ORDER

After consideration of the contentions raised by appellant,
to wit:

1. The government failed to prove an element
of each of the criminal tax offenses charged,

Appendix B

because the defendant maintained inventory in his business, and the government was therefore required to use the accrual method of accounting, rather than the cash method, in computing and assessing his alleged correct tax liability.

2. The trial court erred when refused to provide the jury with sufficient guidance to determine whether the government had met its burden of proof in this case.

a. The trial court should have instructed the jury that the defendant was required by I.R.S. regulation to be an accrual taxpayer and that the government was therefore required to prove the "substantial deficiency" element of its case by the method.

b. Even if it was proper for the court to leave this question of law to the jury, the trial court should have instructed the jury as requested about the legal meaning of (1) inventory under the tax code, and (2) F.O.B. and its relationship to inventory and accrual accounting.

3. In this indirect proof case based on the bank deposits method, the government failed to meet its burden of proof of full and adequate investigation to establish essential accuracy and to investigate leads furnished by the taxpayer with regard to whether the income was taxable in the years in question, because of its unjustified insistence that this was a cash, not an accrual case.

Appendix B

It is

ADJUDGED AND ORDERED that the judgment of the district court be and is hereby affirmed.

By the Court,

s/ (illegible)
Circuit Judge

ATTEST:

s/ Sally Mrvos,
Sally Mrvos, Clerk

DATED: May 2, 1990